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SUBJECT: UKRAINE: NAFTOHAZ OPTIONS FOR GAS PAYMENTS

REF: A. KYIV 1916

[B](#). KYIV 421

[C](#). KYIV 1878

[D](#). KYIV 1943

Classified By: ECON Counselor Edward Kaska for reasons 1.4 (b,d).

[1](#). (C) Summary. Ukraine is expected to need about \$1 billion to cover gas purchased from Russia in November and December. Prime Minister Tymoshenko has called on President Yushchenko to allow the National Bank of Ukraine (NBU) to make its foreign currency reserves available for the gas payments. However, it is unlikely that the President will allow the NBU to do so, which will force the Prime Minister to find alternative sources of funding. GOU officials have said Ukraine will again use IMF Special Drawing Rights (SDRs) to cover the payment for November gas purchases, but predict difficulty making the payment for December gas purchases without IMF stand-by program "fourth tranche" funds. Naftohaz is also in talks with Gazprom Bank to secure alternative financing to cover gas payments. The gas payment situation is unlikely to improve in 2010, even though rates for the transit of Gazprom gas through Ukrainian pipelines to Europe will increase. If Ukraine does miss a gas payment, it will be forced to make prepayments for gas and could be threatened with close to \$9 billion in "take-or-pay" penalties from Russia. End summary.

November 7 Payment for October Gas

[2](#). (C) Per the terms of the January 19, 2009 contract Naftohaz signed with Gazprom, payments are due by the seventh of each month following the month of supply. Ukraine on November 6 paid Gazprom approximately \$461 million for 2.2 billion cubic meters (bcm) of gas purchased in October. According to Naftohaz Spokesman Valentyn Zemlyansky, around \$61 million came from Naftohaz revenues, with the rest coming from IMF SDRs (Ref A). Naftohaz transferred approximately UAH 3.25 billion in treasury bills (from the UAH 18.6 billion that the Cabinet of Ministers allocated to Naftohaz in the summer) to the Ministry of Finance, which in turn transferred \$400 million to a commercial bank for Naftohaz. Zemlyansky claimed that the company earned UAH 3.5 billion (\$435 million) in revenues in October but that a significant portion of the revenues are going to pay Naftohaz's tax burden and service domestic debts. Others estimate that Naftohaz's monthly revenues are significantly less, at around \$130 million.

Gas Volumes for the Rest of the Year

13. (C) While Ukraine's gas purchase volumes for the rest of 2009 will depend somewhat on how cold the winter is, Naftohaz will take far less than it agreed to in the January 19 contract. On October 14 Naftohaz Deputy Director Yaroslav Marchuk stated in the press that Naftohaz would purchase between 7-8 bcm of gas from Gazprom in the fourth quarter. Presidential Envoy for Energy Security Bogdan Sokolovsky told us on November 9 that Naftohaz had earlier planned to take 3.5 bcm in both November and December, but now would likely take around 3 bcm or less, if the winter was mild. Others, however, believe Ukraine could take substantially less gas. Independent energy expert and former Naftohaz official Oleksandr Todiichuk estimated that Ukraine would purchase only 4.5 bcm for the rest of the year. Naftohaz's Zemlyansky told us that Naftohaz would take up to 5 bcm in the last two months of 2009, and could take even less. Minister of Fuel and Energy Yuriy Prodan told the press on November 10 that Ukraine would take between 2.5-2.7 bcm in November. Assuming that the working estimate at Naftohaz is still to take between 7-8 bcm for the fourth quarter, Ukraine will need to purchase between 4.8-5.8 bcm total in November and December at a cost of \$957 million to \$1.17 billion.

Likely Shortfalls

14. (C) The financial situation at Naftohaz will not improve in the final months of the year, and the company will again need some sort of intervention to make its monthly gas payments. Although Zemlyansky's estimate of Naftohaz's revenues was much larger than what others have told us, he also made it clear that the company would not be able to use

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all of its revenues to make the gas payments. Assuming Naftohaz could contribute \$100 million per month from revenues and Ukraine takes on the low side in both November and December, Naftohaz will need approximately \$340 million each month to make up the shortfall. If the winter is colder and Ukraine has to take more gas, the shortfall could grow to approximately \$500 million each month.

Payment Options--National Bank of Ukraine Help Unlikely

15. (SBU) Ukraine has limited options for coming up with the payments, but should be able to make each payment if it has the political will to do so. Yushchenko advisors have repeatedly stated that the President will block any further use of NBU reserves for gas payments. His action rules out the financing scheme Ukraine used for at least three monthly payments earlier this year wherein the NBU provided financing to state-owned banks, which in turn lent the funds to Naftohaz (Ref B). Deputy Presidential Secretariat head Oleksandr Shlapak said in the press that without the IMF releasing the fourth tranche (\$3.8 billion) of the Stand-By Arrangement, Ukraine would have difficulty making the December 7 payment for November gas purchases. Shlapak stated "What do the President and the National Bank have to do with this? It is not the President's duty to pay for gas. It is the duty of the Government."

IMF SDRs Could Be Used

16. (C) The Prime Minister's office also predicts difficulty in making gas payments if the IMF does not give Ukraine the fourth tranche of its Stand-By Arrangement (Ref C), but has stated that Ukraine will be able to make the December 7 payment. Deputy Prime Minister Hryohriy Nemyria stated on November 9 that Ukraine would again use a portion of the IMF SDRs to make the December 7 payment for November gas purchases. He continued by stating that Ukraine would face difficulties making the January 7 payment for December gas purchases if the IMF has not resumed its stand-by program before then. Assuming Ukraine purchases up to \$1.20 billion

worth of gas in November and December, the \$2 billion SDR allocation could cover gas purchases for the rest of the year.

¶17. (C) The GOU, however, could choose to use the SDR funds to cover its own budget gap rather than make the gas payments (Ref D). Sokolovsky told us on November 6 that the SDRs would need to be distributed in a way to "keep happy" Russia, Naftohaz, and the budget. He subsequently told us on November 9 that the SDRs would not necessarily be used to make the December 7 and January 7 payments. Zemlyansky also told us he doubted that the SDRs would be made available to Naftohaz again.

Naftohaz Could Seek Russian Financing

¶18. (C) Another option, which Zemlyansky told us Naftohaz is actively pursuing, would be to borrow from commercial banks. Zemlyansky said specifically that Naftohaz is holding talks with Gazprom Bank to cover gas payments. He said that recent statements made in the press (some made by Zemlyansky himself) that Naftohaz was holding negotiations with Gazprom over changes in the gas contracts were simply cover for the actual talks--securing financing from Gazprom Bank--that were ongoing. Zemlyansky did not comment on the loan terms being discussed or what Naftohaz might offer as collateral. Naftohaz Deputy Chairman Igor Didenko, reported to be Tymoshenko's man at Naftohaz, has frequently shuttled between Kyiv and Moscow over the last month.

Growing Debts Owed to Naftohaz

¶19. (SBU) Naftohaz could also seek to collect growing arrears owed to the company from municipal heating companies and Oblgas companies (regional gas distributors). Prime Minister Tymoshenko has stated that municipal heating companies have a 50-60% payment rate to Naftohaz. Heating companies still owe Naftohaz UAH 2.7 billion (\$330 million) from gas purchased in ¶2008. With the continued economic slump and the lack of political will at the municipal government level to raise heating tariffs, it is unlikely that heating company debts

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will be paid off to Naftohaz this year.

¶10. (SBU) Over the summer the Cabinet of Ministers established a financing program intended to provide loans from state-owned banks to cities to repay municipal heating company gas debts. According to Zemlyansky, the program has not been very successful as the banks have little liquidity and are not extending loans to municipalities.

¶11. (SBU) Zemlyansky also told us that Oblgas companies are refusing to pay for gas sold to them and have amassed UAH 12 billion (\$1.47 billion) in debts. Oblgas companies' refusal to pay for gas supplies is linked to a decision passed by the Cabinet of Ministers on June 10 to strip the gas distribution business from them and give it to a new subsidiary of Naftohaz, Naftohaz Merezh, at the beginning of 2010. If Naftohaz or the government were able to enforce payment discipline by heating and Oblgas companies, Naftohaz would have enough resources to make the payments for gas taken in November and December.

Payment Problems Will Continue

¶12. (SBU) Ukraine's ability to pay for Russian gas will continue to be limited in 2010. The January 19 contract envisions a marked increase in gas volumes delivered to Ukraine from 40 bcm in 2009 to 52 bcm in 2010. The government and Naftohaz reportedly have begun talks with Gazprom to lower the contracted volume for 2010 to 33 bcm. On January 1, gas prices will also increase as Ukraine loses

the 20% discount it had in 2009, and as the new quarter begins. The first quarter price will be at least \$260 per thousand cubic meters (tcm) compared to \$208/tcm for the fourth quarter of 2009. The draft 2010 budget submitted by the Cabinet of Ministers to the Rada on September 15 uses an average gas price of \$260/tcm for 2010 to calculate subsidies for Naftohaz. Zemlyansky, however, told us that Naftohaz estimates that the average price for 2010 will be \$295/tcm (compared to an average price of \$235/tcm in 2009). Assuming Ukraine purchases 33 bcm in 2010, at an average price of \$260/tcm, Ukraine will need to pay Gazprom \$8.58 billion. Assuming an average price of \$295/tcm, the bill would jump to \$9.74 billion. Ukraine's total gas bill in 2009 will be approximately \$5.6 billion for around 24 bcm.

Transit to Increase, But Won't Cover Growing Gas Payments

¶13. (SBU) Per the January 19 transit contract, the pipeline transit rate should also increase beginning January 1, 2010. Naftohaz estimates that the rate will increase from the current rate of \$1.70/tcm per 100 kilometers to \$2.70/tcm per 100 kilometers. Ukraine could earn around \$3-3.5 billion in transit revenues for 2010, an extra \$1-1.5 billion compared to 2009, depending on volumes shipped to Europe. However, as Russia advanced Ukraine close to \$2 billion for transit at the beginning of 2009, Naftohaz will not start collecting transit revenue again until sometime in the spring of 2010, at the earliest in March.

What Would a Missed Payment Mean?

¶14. (SBU) If Ukraine misses a payment, per the terms of the contract, Naftohaz will be forced to prepay for gas deliveries before the beginning of each month. Already in dire financial straits, Naftohaz would probably not be able to prepay Gazprom. A missed payment could also spark Russia to threaten Ukraine once again with "take-or-pay" penalties for the under-purchase of gas in 2009. Gazprom estimates that total penalties from January-September 2009 total \$5.9 billion. According to the Presidential Secretariat, total penalties in 2009 could reach \$8.7 billion. While Putin and Tymoshenko have agreed in principle that Ukraine would not be penalized for under-purchase of gas, this agreement has not been formalized in writing. Most analysts in Kyiv expect that Russia will not sign a legal agreement ceding Gazprom's rights to impose penalties. Indeed, many here expect that Russia would threaten Ukraine with penalties should Ukraine's new president act against Moscow's interests.

¶15. (C) Putin also has again warned that Russia would turn off the gas to Ukraine if Ukraine siphons off transit gas for its own use. If Russia turned off gas to Ukraine, transit to

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Europe would be threatened. Ukraine has enough gas in its underground storages to meet domestic needs over the winter, but it would not be able to meet its own needs and transit gas to Europe if Russia turns off the gas flows. Hans Rhein, the EC Delegation's energy expert, told us that a growing concern for the EU was that Ukraine would siphon gas off the transit pipeline if the winter is particularly harsh. He said that while Ukraine has enough gas in storage to replace whatever gas it might siphon from the transit pipeline, the transit system might not have the capability to evenly "swap" the gas in storage with the gas Ukraine would take off the pipeline. If it seemed that Ukraine might start to siphon off gas from the pipeline, the EU could consider placing monitors in Kyiv as it had done in January in an effort to avoid a shut off, according to Rhein.

Comment

¶16. (C) Although Ukraine has significantly reduced the

volumes of gas it plans to purchase from Russia, political infighting between the President and the Prime Minister and the dire straits of the government's budget could lead to gas payment problems over the winter. Yushchenko looks determined to reject the Prime Minister's request to use NBU reserves for the gas payment, and by so doing, to create more problems for Tymoshenko. For Tymoshenko, making the gas payment with SDRs or other government revenues could mean increasing the risk that pensions and wages could go into arrears, just ahead of the presidential election. Tymoshenko could be willing to deepen Ukraine's dependency on Russia by forcing Naftohaz to take Russian loans for gas purchases as a short-term tradeoff to forestall a gas payment crisis and keep the government's budget afloat. Tymoshenko could also be playing chicken with the IMF and the EU by threatening that Ukraine could miss a payment without their fiscal support. Gazprom meanwhile has again ramped up its public relations campaign to assign blame to Ukraine for any possible future gas crisis. Russia, by repeatedly warning that Ukraine might miss a payment, is reviving its theme that Ukraine is an unreliable transit partner. Russia also seems to be setting the stage to blame the EU, at least in part, for a future gas crisis by criticizing the EU's decision not to extend financing to cover Ukrainian gas purchases.

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